



WALTER SMITH
Executive Director

BOARD OF DIRECTORS

CHAIR: PAT BRANNAN
Hogan Lovells

VICE CHAIR: JON BOUKER
Arent Fox LLP

VICE CHAIR: MARGARET SINGLETON
DC Chamber of Commerce

SECRETARY: DEBORAH CHOLLET
Mathematica Policy Research, Inc.

TREASURER: JAMES H. HAMMOND
Deloitte & Touche LLP

PAST CHAIR: GARY EPSTEIN
Federal Communications Commission

PAST CHAIR: RICHARD HERZOG
Harkins Cunningham LLP

PAST CHAIR: NICK FELS
Covington & Burling LLP

NEIL ALBERT
Holland & Knight

STEVE BASKIN
Kilpatrick Townsend & Stockton LLP

RICK BRESS
Latham & Watkins LLP

KATHERINE S. BRODERICK
*University of the District of Columbia –
David A. Clarke School of Law*

PATRICK CAMPBELL
*Paul, Weiss, Rifkind, Wharton &
Garrison LLP*

SHELDON COHEN
Farr, Miller & Washington, LLC

ANMARGARET CONNOLLY
Weil, Gotshal & Manges LLP

MARC EFRON
Crowell & Moring LLP

FRED GOLDBERG
Skadden

JANIE JEFFERS
Jeffers & Associates LLC

BOB LEVEY
Journalist

LORIE MASTERS
Jenner & Block LLP

JAMES RATHVON
DLA Piper US LLP

RUSS RANDLE
Patton Boggs LLP

GARY RATNER
Citizens for Effective Schools, Inc.

AMY P. RIFKIND
Arnold & Porter LLP

ELEANOR SMITH
Zuckerman Spaeder, LLP

WILLIAM STEIN
Hughes, Hubbard & Reed LLP

TED TRABUE
DC Sustainable Energy Utility

STEPHANIE TSACOMIS
Georgetown University

MATTHEW YEO
Step toe & Johnson LLP

February 22, 2013

Ms. Sarah Schroeder
c/o District of Columbia Department of Insurance, Securities and Banking
810 First Street NE
Suite 701
Washington, D.C. 20002

Re: Surplus Review of Group Hospitalization and Medical
Services, Inc.

Dear Ms. Schroeder:

We want to follow up on the meeting Rector & Associates held with GHMSI and DC Appleseed on February 4. We continue to appreciate that Rector is holding these meetings and believe they are helpful both in producing a useful exchange of views and in moving the parties closer to agreement about how best to determine the maximum permissible surplus for GHMSI under the standards in the MIEAA. As you know, at the February 4 meeting there was not agreement about how this might be done.

Based on the conversation at that meeting and our further thinking, we are writing now to (1) explain our thinking that Rector's work should incorporate the MIEAA's "maximum feasible" standard; and (2) propose how Rector might apply this standard in a way that is fully consistent with Rector's commitment to using the best actuarial approach to the task presented.

1. Rector Should Incorporate the MIEAA in Its Work

As we said at the February 4 meeting, we believe it is important that the surplus level for GHMSI that Rector presents to the Commissioner accord with and take into account the MIEAA standards. We say that for several reasons.

First, Rector's work will be most useful to the Commissioner if it already takes account of the MIEAA standards. Indeed, Rector acknowledged in its initial and rebuttal reports submitted to the DISB in the prior surplus proceeding that its work must relate to the governing D.C. law. Rector made clear that calculations of surplus needed to avoid the 200% and 375% RBC levels are useful only

insofar as they help one to “reach conclusions regarding how GHMSI’s surplus compares to the thresholds in DC law and regulations.”¹

We understand from the February 4 meeting that Rector intends to calculate and present the level of surplus GHMSI needs to avoid falling below 200% RBC with 98% confidence to the Commissioner as its primary recommendation. Rector should calculate a “useful” number which, by taking account of the MIEAA standards, helps the Commissioner “reach conclusions regarding how GHMSI’s surplus compares to the thresholds in DC law and regulations.”

In fact, if Rector does not do that, it is not clear to us—or apparently to GHMSI—how the Commissioner could use Rector’s work to ensure that GHMSI’s surplus complies with the MIEAA standards. GHMSI asserted at our recent meeting that Rector should not take account of the MIEAA standards in its work, suggesting instead that Rector should leave it to the Commissioner to find a way to apply the statute after the fact. But when we asked GHMSI how it thought the Commissioner might do this, the company had no response. In our view, there is no good response to our question.

The catalyst and purpose of Rector’s current work is to ensure compliance with the MIEAA in the wake of the Court of Appeals’ decision. Rector itself acknowledged this in its October 2012 “Approach to Review.” There it noted that it had “been retained . . . in accordance with” the MIEAA to examine [GHMSI] and to assist with DISB’s review of the surplus.”² It also noted that the Court’s decision “was taken into account in developing the approach.”³ The Court determined that the “primary motivation” for the MIEAA was the “maximum feasible” obligation⁴ and remanded to the DISB for “further proceedings not inconsistent with this opinion.”⁵ It would leave the Commissioner in a difficult position if Rector were to conduct an analysis that ignores the MIEAA and then requires the Commissioner to reconcile that analysis with the Court’s mandate by making after-the-fact adjustments that have not yet been identified. It is by far preferable that Rector take account of the MIEAA standards in the first instance.

Second, we think that leaving application of the MIEAA to an uncertain later stage would be inconsistent with the Commissioner’s expressed intention to have a reliable, self-executing model that will determine GHMSI’s permissible surplus on an ongoing, objective basis, rather than through later subjective, ad hoc adjustments of the numbers produced by the model. At the very least, it seems to us that if a model is to be constructed that takes no account of the MIEAA, there should be an effort to reach agreement concerning how the numbers produced by the model might be adjusted after the fact, on a principled basis, to bring the numbers into compliance with

¹ Rector & Assocs., *Rebuttal to September 3, 2010 Supplemental Report on Effects of Federal Health Care Reform as Submitted by Group Hospitalization and Medical Services, Inc.* 3 (Sept. 20, 2010); Rector & Assocs., *Report to the D.C. Department of Insurance Securities and Banking: Group Hospitalization and Medical Services, Inc.* 4–5 (2010).

² Rector & Assocs., *Approach to Review of Surplus of Group Hospitalization and Medical Services, Inc.* 1 (October 2012).

³ *Id.*

⁴ *D.C. Appleseed Ctr. for Law & Justice v. D.C. Dep’t of Ins., Secs. & Banking*, No. 10-11-1461, at 51 (D.C. Sept. 13, 2012).

⁶ *Id.* at 59.

the MIEAA. But as we said earlier, we do not know, and GHMSI has not suggested, what those principled adjustments might be.

Finally, the Court itself contemplated that Rector's work would guide the Commissioner in applying the MIEAA standards. For example, in overturning the previous surplus decision, the Court noted that the previous Commissioner had relied on surplus levels related to 98-99% confidence of avoiding 200% RBC and 95% of avoiding 375% RBC, but there had been "no explanation why the Commissioner thought it was necessary to have such high confidence levels for these thresholds...."⁶ Similarly, the Court noted that because the Commissioner did not take into account GHMSI's "community reinvestment" obligation under the MIEAA, "no consideration [was] given to calibrating the level of confidence in each of the thresholds accordingly."⁷ And perhaps most significantly, the Court noted that Milliman's suggested surplus ranges failed to "take into account the obligation to reinvest in the community to the maximum extent feasible," and that "[t]he Commissioner's own expert, Rector, did not provide a range, or characterize the RBC-ACL ratio it determined as 'acceptable' or 'optimal' in light of this obligation."⁸

Taken together, the Court's observations make clear that it expects the RBC thresholds, the confidence levels associated with them, and the resulting recommended surplus all to be directly tied to the MIEAA standards, and that the experts themselves (including Rector) should ground their recommendations in those standards.

In summary, Rector's work should take account of the MIEAA standard because the Court's decision contemplates that approach, and because Rector's ensuing recommendation will be vastly more useful to the Commissioner in that it will be fully consistent with his goal of instituting an objective and self-executing model.

2. Rector Should Apply the MIEAA Standards by Selecting Model Assumptions Drawn from Actual Historical Performance

By proposing that Rector take GHMSI's "maximum feasible" obligation into account, we in no way suggest that Rector should do anything to compromise or skew the application of a sound actuarial approach. Rather, as explained above, we believe that Rector has been asked to conduct an actuarial analysis taking into account a very particular statutory context. Specifically, we think Rector is being asked to offer its best actuarial judgment concerning the amount of GHMSI surplus that will comply with the MIEAA's "maximum feasible" requirement. To state the issue as we proposed it at the February 4 meeting, Rector is being asked to calculate the lowest level of GHMSI surplus that is both sound and efficient.

The statute is structured so that financial efficiency dictates the upper bound on surplus that is consistent with financial soundness. Efficiency generally means achieving some desired result at

⁶ *Id.* at 59.

⁷ *Id.* at 60 (emphasis added).

⁸ *Id.* at 60 n.42 (emphasis added).

the lowest possible cost. Here, the desired result is financial soundness; and the cost to be minimized is the cost to subscribers, from whose premiums (along with investment income) surplus derives. An efficient surplus, in turn, identifies GHMSI's maximum feasible community health reinvestment; surplus held beyond what is efficient, while it may be consistent with financial soundness, means that GHMSI is retaining dollars that can feasibly be directed to community reinvestment.

We understand that Rector intends to calculate GHMSI's permissible surplus primarily by calculating the level need to avoid falling below 200% RBC with 98% confidence. The Court has made clear that setting such a high confidence level must be justified under the "maximum feasible" standard. In our view, Rector can justify using a 98% confidence level by applying the maximum feasible standard in a relatively straightforward manner, in two steps.

First, Rector would formulate each assumption in the model in the manner we understand Rector is already planning to do—by using the 50th percentile for each assumption. These assumptions should reflect Rector's best estimate of the most likely occurrences based on GHMSI's historical performance. A valid model would then produce a gain/loss distribution that is consistent with GHMSI's experience over the last 15 years—i.e., a mid-point annual underwriting gain of 1.5% with variability consistent with actual GHMSI results over the last 15 years (where the actual largest underwriting gain has been 3.9% and the largest underwriting loss has been 0.1%); and a resulting gain/loss distribution where approximately 95.4% of results would be within two standard deviations of the historic mean, or between a 3.7% gain and a 0.7% loss. This approach would both account for routine fluctuations in results and validate the model against historical experience.

Second, Rector would base the loss variability in the tails (i.e., the remaining 2.3% of the gain/loss distribution in each tail that accounts for potential non-routine fluctuations) on reasonably possible non-routine gains and losses that are outside the last 15 years of GHMSI experience. To the extent possible, these non-routine gain/loss probabilities should be based on the actual experience of non-routine events (such as hurricanes or flu epidemics) that have affected various Blues plans over the last 30-plus years and might conceivably occur in the future.

An example of what *should* be utilized in determining tail probabilities would be the impact of the small group rating reforms that occurred in the early 1990s. The small group rating reform impact on underwriting results may be analogous to the unforeseeable impacts of the PPACA. What *should not* be covered in the tail probabilities are the gains and/or losses from historic underwriting cycles. These historical cycles, which were once routine fluctuations, have disappeared entirely from industry experience over the last 15 years for structural reasons;⁹ they are not expected to recur in the future.

⁹ Mark E. Shaw, *Is There Currently an Underwriting Cycle?*, Health Watch (Soc. of Actuaries/Health Section, Schaumburg, Ill.), Oct. 2012; Letter from Walter Smith, Exec. Dir., DC Appleseed Ctr., et al., to Philip Barlow, Assoc. Comm'r for Ins., D.C. Dep't of Ins., Secs. & Banking (July 31, 2012).

We anticipate that building these tail probabilities will be the most difficult part of Rector's modeling process. We also believe that choosing the historical or future variability to include in the tail probabilities will inevitably involve some judgment; it will depend on but may not be limited to the cataloguing of facts. It is our belief that the MIEAA standard should inform the various judgments that will necessarily be made and that the use of extreme, unreasonable scenarios with scant likelihood is inconsistent with the MIEAA's co-mandates of soundness and efficiency. That is, marginal protection against an unreasonably extreme risk should not outweigh the certainty of taking funds from other community health needs; the DC Council has already made that trade-off by requiring the "maximum feasible" community reinvestment and financial "efficiency." The modeled tail loss possibilities and associated probabilities will need to be fully disclosed so that all parties will have the chance to review and comment on them, with a view toward achieving consensus if possible.

Building the model in this way is fully consistent with both the MIEAA and the Commissioner's goals. It will ensure that GHMSI's surplus is both sound and efficient. Coincidentally, it will build on concepts developed by the Pennsylvania Commissioner, while recognizing, as an acceptable model must, that the MIEAA requires a higher standard.

In Pennsylvania, the Commissioner recognized that principles of economic efficiency apply to surplus; in particular, that there are diminishing returns to surplus accumulation and marginal reductions in risk must be balanced against alternative uses of the funds.¹⁰ The Pennsylvania Commissioner considered an efficient level of surplus for a Blue Plan to be one in which the Plan does not face solvency issues from routine fluctuations.¹¹ The Commissioner further recognized that some additional accumulation would be allowed to the point of "inefficient" (i.e., inefficiently high) surplus.¹² In the Pennsylvania statute, there was no identification of competing uses of the funds, no statutory guidance on what the proper balance was between further accumulation and competing uses, no mandate to maximize competing uses to the extent feasible, and, therefore, no directives by which to establish the upper limit.

The MIEAA, by explicitly requiring financial "soundness," recognizes the need for protection against both routine fluctuations and some reasonable, experienced-based estimates of non-routine fluctuations. In contrast to the Pennsylvania statute, however, the MIEAA identifies community health reinvestment as the competing use of funds; mandates that the "maximum feasible amount" of funds be directed to that use; and, to achieve that result, places an upper limit on "soundness" by directing the Commissioner to identify the "efficient" level of surplus, which, given the MIEAA's overarching purpose, is the level at which, and not beyond, the surplus provides an acceptably high probability of soundness.

¹⁰ *In re: Applications of Capital BlueCross, Highmark Inc., Hospital Service Association of Northeastern Pennsylvania d/b/a Blue Cross of Northeastern Pennsylvania and Independence Blue Cross for Approval of Reserves and Surplus*, Misc. Dkt. No. MS05-02-00615, Insurance Dep't of the Commonwealth of Pennsylvania (Feb. 9, 2005) at 15.

¹¹ *Id.* at 34.

¹² *Id.* at 37.

We hope these further thoughts are helpful. We appreciate the opportunity to have input in this process, and we look forward to continuing to work together toward reaching a consensus on the appropriate level for GHMSI's surplus.

Sincerely,



Walter Smith, Executive Director
DC Appleseed Center



Richard B. Herzog
Harkins Cunningham LLP



Deborah Chollet, Ph.D.



Marialuisa S. Gallozzi
Covington & Burling LLP

cc: The Honorable William P. White, Commissioner, D.C. Department of Insurance,
Securities and Banking
Mr. Philip Barlow, Associate Commissioner for Insurance, D.C. Department of
Insurance, Securities and Banking
Mr. Thomas M. Glassic, General Counsel, D.C. Department of Insurance, Securities and
Banking